

Message Text

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LIMITED OFFICIAL USE SECTION 1 OF 2 EC BRUSSELS 06807

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SUBJECT: EC COMMISSION ADOPTS DRAFT DIRECTIVE TO ESTABLISH AN
EC CORPORATE TAX SYSTEM

REF: EC BRUSSELS 6924, NOVEMBER 29, 1973

1. BEGIN UNCLASSIFIED/BEGIN SUMMARY: THE COMMISSION HAS PROPOSED THAT THE EC ADOPT A PARTIAL IMPUTATION SYSTEM FOR CORPORATE DIVIDENDS WHICH ALLOWS TAXPAYERS TO CREDIT PART OF THE TAX ON DISTRIBUTED PROFITS AGAINST THEIR TAX LIABILITY. THIS SYSTEM WOULD REMOVE THE DOUBLE TAXATION OF SHAREHOLDER INCOME THAT EXISTS IN SOME MEMBER STATES. THE DRAFT ALSO PROPOSES ESTABLISHING A COMMUNITY-WIDE 25 PERCENT WITHHOLDING TAX ON DIVIDENDS. THE DRAFT WOULD DISCRIMINATE AGAINST THIRD COUNTRY INVESTORS WHOSE TAX AUTHORITIES DO NOT USE THE IMPUTATION SYSTEM. SEVERAL MEMBER STATES ARE AGAINST THIS DIRECTIVE AND IT WILL LIKELY BE AT LEAST SEVERAL YEARS BEFORE IT IS ADOPTED. END SUMMARY.

2. THE EC COMMISSION ADOPTED A DRAFT DIRECTIVE ON JULY 23 WHICH CALLS UPON THE EC TO ESTABLISH A "PARTIAL IMPUTATION"--TAX CREDIT--SYSTEM FOR CORPORATE DIVIDENDS, AND A 25 PERCENT WITHHOLDING TAX ON DIVIDEND

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INCOME. (COPIES OF THE DRAFT DIRECTIVE HAVE BEEN

SENT TO INTERESTED WASHINGTON AGENCIES, INCLUDING RPE/CLARK.) THE DRAFT AIMS TO REMOVE CONSTRAINTS ON CAPITAL MOVEMENTS AND TO INCREASE COMPETITION IN THE EC. THE COMMISSION BELIEVES ITS PROPOSAL OFFERS A MORE NEUTRAL APPROACH TOWARD THE TAXATION OF BUSINESS PROFITS THAN MOST MEMBER STATES CURRENTLY OFFER. ITS PROPOSAL IS ALSO DESIGNED TO ENHANCE TAX EQUITY, BECAUSE IT WILL REDUCE DOUBLE TAXATION OF CORPORATE DIVIDENDS AND ENCOURAGE THE DISTRIBUTION OF DIVIDENDS. IT ALSO AIMS TO REDUCE TAX EVASION AND TO ENCOURAGE RELATIVELY SMALL SAVERS TO BUY CORPORATE STOCKS.

3. THE DRAFT DIRECTIVE REQUIRES EACH MEMBER STATE TO APPLY A SINGLE TAX RATE TO CORPORATE PROFITS, WHETHER DISTRIBUTED OR UNDISTRIBUTED. THIS RATE WOULD BE BETWEEN 45-55 PERCENT, UNLESS A MEMBER STATE REQUESTS AN EXEMPTION FOR OVER-RIDING POLITICAL, ECONOMIC OR SOCIAL REASONS. RESIDENTS OF ANY MEMBER STATE HAVE A RIGHT TO A TAX CREDIT WHEN RECEIVING A DIVIDEND DISTRIBUTED BY A MEMBER STATE CORPORATION. MEMBER STATES ARE ASKED TO SET A TAX CREDIT RATE WHICH WOULD BE BETWEEN 45-55 PERCENT OF THE "GROSSED UP" CASH DIVIDEND, I.E., PART OF THE CORPORATE TAX LIABILITY IS ADDED TO THE RECIPIENT'S TAX LIABILITY. THE CREDIT IS THEN APPLIED AGAINST THE TAX ON INCOME OR PROFITS FOR WHICH THE RECIPIENT IS LIABLE.

4. FOR EXAMPLE, ASSUMING A DIVIDEND OF 100 AND A TAX CREDIT RATE OF 50 PERCENT, THE "GROSSED UP" TAXABLE INCOME IS 150. IF THE RECIPIENT'S TAX RATE IS 40 PERCENT, THE AMOUNT OF TAX HE IS TO PAY IS 10, I.E., 60 (40 PERCENT OF 150) MINUS 50 (TAX CREDIT). IF THE TAX LIABILITY IS LESS THAN THE TAX CREDIT OF 50, HE RECEIVES THE DIFFERENCE BETWEEN THE TAX CREDIT AND THE AMOUNT OF THE TAX. IF HIS INCOME DOES NOT REACH THE MINIMUM TAX LIABILITY, THE RECIPIENT RECEIVES THE FULL TAX CREDIT.

5. THE BUDGETARY COST OF THE TAX CREDIT IS LIMITED OFFICIAL USE

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BORNE BY THE MEMBER STATE IN WHICH THE CORPORATION THAT DISTRIBUTES THE DIVIDEND IS LOCATED. WHEN A PARENT CORPORATION RESIDENT IN A MEMBER STATE DISTRIBUTES DIVIDENDS COMING FROM THE PROFITS OF A SUBSIDIARY IN ANOTHER MEMBER STATE, THE STATE OF THE SUBSIDIARY PAYS THE STATE OF THE PARENT CORPORATION THE AMOUNT OF THE TAX CREDIT DERIVED FROM THE SUBSIDIARY'S PROFITS. PROVISIONS ARE INCLUDED,

HOWEVER, FOR MEMBER STATE BILATERAL AGREEMENTS WHICH
WOULD ALLOW STATES TO SHARE THE COSTS OF THE TAX
CREDIT.

6. IN CASE OF A DOUBLE TAXATION AGREEMENT BETWEEN
A MEMBER STATE AND A THIRD-COUNTRY, TAX CREDITS MAY
BE GRANTED TO PERSONS RESIDENT IN THIRD COUNTRIES.
IN NO CIRCUMSTANCES, HOWEVER, MAY SUCH PERSONS BE
TREATED MORE FAVORABLY THAN PERSONS RESIDENT IN THE
COMMUNITY. MEMBER STATES ARE ASKED TO COOPERATE IN
ADOPTING A COMMON POSITION ON THIS MATTER.

7. BEGIN LIMITED OFFICIAL USE/BEGIN COMMENT: THE
EC HAS NOT YET BEGUN TO DISCUSS A COMMON POSITION
TOWARD TAX AGREEMENTS WITH THIRD COUNTRIES. THE COM-
MISSION HAS ASKED MEMBER STATES WHICH ARE NEGOTIATING
TAX AGREEMENTS TO ADOPT SUCH AGREEMENTS ONLY ON A
PROVISIONAL BASIS SO THAT THEY MIGHT SUBSEQUENTLY BE
MODIFIED TO CORRESPOND TO A COMMON EC POSITION. THE
DRAFT DOES NOT PROVIDE FOR GRANTING TAX CREDITS TO
PARENT CORPORATIONS OF THIRD COUNTRIES WHICH HAVE EC
SUBSIDIARIES. COMMISSION OFFICIALS BELIEVE THE EC
AND THIRD COUNTRY CORPORATE TAX SYSTEMS MUST FIRST
BE HARMONIZED BEFORE SUCH AN ARRANGEMENT WOULD BE
FEASIBLE. OTHERWISE, THIRD COUNTRY PARENT COMPANIES
COULD OBTAIN TAX ADVANTAGES WHICH WOULD CREATE DISTORTIONS IN
CAPITAL FLOWS. END COMMENT.

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8. BEGIN UNCLASSIFIED. THE DRAFT DIRECTIVE REQUIRES EACH MEMBER STATE TO IMPOSE A WITHHOLDING TAX OF 25 PERCENT OF THE DIVIDENDS DISTRIBUTED BY RESIDENT CORPORATIONS, NO MATTER WHO IS THE RECIPIENT. (THIS PROVISION IS SUBJECT TO EXISTING TAX CONVENTIONS BETWEEN MEMBER STATES AND THIRD COUNTRIES.) THE WITHHELD TAX, HOWEVER, MAY BE APPLIED AGAINST THE AMOUNT OF TAX ON INCOME OR PROFITS WHICH IS PAID OUT AS DIVIDENDS. THE WITHHELD TAX IS THUS REPAID IN CASES IN WHICH IT EXCEEDS THE RECIPIENT'S TAX LIABILITY. THE REPAYMENT MAY BE DELAYED, HOWEVER, BECAUSE THE TAX CREDIT IS NOT PAID UNTIL THE END OF THE FISCAL YEAR. WHEN THE WITHHOLDING TAX WHICH IS COLLECTED BY ONE MEMBER STATE IS SET OFF OR REPAID IN ANOTHER MEMBER STATE, THE STATE WHICH COLLECTED THE TAX SHALL REFUND IT TO THE OTHER STATE.

9. THE COMMISSION BELIEVES THE PROPOSED WITHHOLDING TAX IS ESSENTIAL TO PREVENT TAX EVASION, ESPECIALLY BY TAXPAYERS IN A HIGH TAX BRACKET. THE TAX CREDIT PROVIDES A DEDUCTION OF ABOUT ONE-THIRD OF TAXABLE INCOME, BUT MANY SHAREHOLDERS HAVE A HIGHER PERSONAL TAX RATE. THE WITHHOLDING TAX WOULD RAISE THE TOTAL DEDUCTION AT SOURCE TO ABOUT 50 PERCENT OF TAXABLE INCOME, WHICH REDUCES THE INCENTIVE TO EVADE PAYING LIMITED OFFICIAL USE

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THE TAX ON DIVIDENDS.

10. BEGIN LIMITED OFFICIAL USE. COMMISSION OFFICIALS BELIEVE IT WILL TAKE AT LEAST TWO YEARS BEFORE THE COUNCIL IS PREPARED TO ADOPT THE DRAFT DIRECTIVE. AFTER HOLDING EXTENSIVE TECHNICAL DISCUSSIONS WITH MEMBER STATE TAX OFFICIALS, THEY BELIEVE MOST OF THE DRAFT'S TECHNICAL PROBLEMS HAVE BEEN RESOLVED. COMMISSION OFFICIALS SAY, HOWEVER, THAT SEVERAL MEMBER STATES HAVE RESERVATIONS OVER THE DRAFT. THE NETHERLANDS AND LUXEMBOURG DO NOT WANT TO CHANGE THEIR CURRENT "CLASSIC" APPROACH. THE FRG WANTS TO SPLIT THE TAX RATE DEPENDING ON WHETHER CORPORATE PROFITS ARE DISTRIBUTED OR NOT. SOME STATES ALSO DISAGREE OVER SPECIFIC PROVISIONS SUCH AS THE PROPOSED WITHHOLDING TAX AND THE RELATIONSHIP BETWEEN PARENT AND SUBSIDIARY FIRMS.

11. COMMISSION OFFICIALS ARE CONCERNED OVER US EFFORTS TO RENEGOTIATE ITS TAX TREATY WITH THE UK. THE US REPORTEDLY WANTS THE UK TO GRANT A TAX CREDIT TO US

PARENT CORPORATIONS WHO RECEIVE A DIVIDEND FROM THEIR BRITISH SUBSIDIARIES. THE COMMISSION IS CONCERNED THAT SUCH AN ARRANGEMENT WOULD FORCE OTHER MEMBER STATES TO ADOPT A SIMILAR APPROACH TOWARD US INVESTMENTS IN ORDER TO AVOID DISTORTIONS IN CAPITALS FLOWS. COMMISSION OFFICIALS WOULD PREFER TO DELAY SUCH NEGOTIATIONS UNTIL THE EC HAS DECIDED ON A COMMON APPROACH ON THIS MATTER. ON THE OTHER HAND, THEY CONCEDE IT WILL LIKELY BE SOMETIME BEFORE THE MEMBER STATES HAVE ADOPTED A COMMON APPROACH.

12. COMMENT: THE IMPUTATION SYSTEM COULD BE INEQUITABLE AND COULD HAVE UNDESIRABLE CONSEQUENCES WITH REGARD TO INTERNATIONAL CAPITAL FLOWS. THIRD COUNTRIES WHICH DO NOT USE THE IMPUTATION SYSTEM COULD FIND THAT EC INVESTORS WILL NOT BE AS INTERESTED IN INVESTING IN THEIR CORPORATIONS AS THE EC'S BECAUSE THE RETURN AFTER PERSONAL TAXES WOULD LIKELY BE HIGHER FROM AN EC EQUITY INVESTMENT THAN A THIRD COUNTRY'S. SIMILARLY, THE THIRD COUNTRY PARENT CORPORATION WOULD BE DISCRIMINATED AGAINST BECAUSE IT WOULD NOT BE ENTITLED TO A TAX LIMITED OFFICIAL USE

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CREDIT. THUS, WITHOUT A TAX TREATY TO REMOVE THESE DISCRIMINATORY EFFECTS, THE EC'S ADOPTION OF AN IMPUTATION SYSTEM WILL TEND TO RESTRICT CAPITAL FLOWS BETWEEN THE EC AND THIRD COUNTRIES. COMMISSION OFFICIALS RECOGNIZE THESE DIFFICULTIES BUT INDICATE THAT THE DIVERGENCE IN MEMBER STATE TAX SYSTEMS CURRENTLY CONSTRAINS CAPITAL MOVEMENTS WITHIN THE COMMUNITY. THEY BELIEVE THE IMPUTATION SYSTEM IS THE MOST EQUITABLE AND NEUTRAL SYSTEM THAT THE EC CAN ADOPT. END COMMENT. MORRIS

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